

***United States Court of Appeals
for the Second Circuit***



PETITION

77-7060

United States Court of Appeals

FOR THE SECOND CIRCUIT

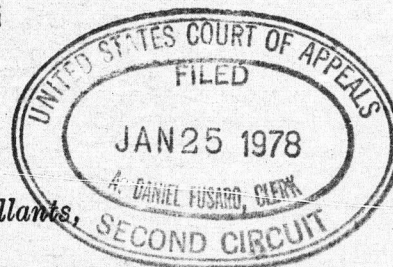
HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

—against—

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F.
CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P.
HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MON-
RONEY, CHARLES F. PHILLIPS, JEPHTHA H. WADE, ANCHOR
CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.



ON APPEAL FROM ORDERS AND JUDGMENT OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

**PETITION BY APPELLEES FOR REHEARING
IN BANC**

(For List of Counsel, see inside)

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Statement of the Case for Rehearing
in Banc

Judge Lumbard, writing for the panel that decided this appeal on January 11, 1978 (Oakes, P.J., Lumbard, and Meskill, J.J.) recognized the exceptional importance of this case (see FRAP 35(a)), when he stated, in the opening sentence of his opinion, "This appeal by two mutual fund shareholders raises an important question of first impression..." [emphasis supplied] (Slip Opinion, p. 992).

The decision of the panel constitutes a grave and insupportable excursion into judicial legislation. Judge Lumbard's opinion engrafts hypothesized limitations onto the business judgment powers of disinterested directors of mutual funds not placed there by Congress in the Investment Company Act of 1940 ("the Act"), and overlooks or misapprehends sound precedents in irreconcilable conflict with his opinion (a) in this Court, (b) in the Court of Appeals for the First Circuit, and (c) in the Supreme Court of the United States.

Judge Lumbard, in reversing the District Court (Werker, J.), held as a matter of law that the disinterested directors of Fundamental Investors, Inc. ("Fundamental"), a mutual fund, acting in good faith, with care and deliberation and with the advice of distinguished independent counsel --- Hon. Stanley H. Fuld, former Chief Judge of the State of New York --- did not have the power to exercise their business judgment to terminate a derivative action

on behalf of Fundamental against Anchor Corporation ("Anchor") (the investment adviser to Fundamental) and various individuals, the maintenance of which the disinterested directors had determined to be contrary to the best interests of the shareholders of Fundamental.

The decision and the opinion by Judge Lumbard do not withstand analysis and should be reversed by this Court.

Statement of the Facts

On November 26, 1969, Fundamental purchased from Goldman, Sachs & Co., a commercial paper dealer, \$20 million of the 270-day notes of Penn Central as a short-term utilization of unemployed cash (36 A).

On June 21, 1970, Penn Central filed a Petition for Reorganization, and the notes purchased by Fundamental (and many other financial institutions, universities, charitable organizations, etc.) were not paid at maturity. Penn Central is still in reorganization.

On November 4, 1970, Fundamental initiated an action, with three other plaintiffs, against Goldman, Sachs & Co. ("the Welch action") for rescission of their purchase of the notes (36 A).

On February 5, 1973, nearly four years after the purchase by Fundamental, two stockholders of Fundamental commenced the instant derivative action ("the Lasker action") allegedly on behalf of Fundamental (2 A). The Complaint charged Anchor, and all of the directors of Fundamental at the time of the purchase (i.e. 1969), with violations of statutory and common law duties in making and retaining the investment in Penn Central.

On July 9, 1974, on the eve of trial of the Welch action, Fundamental settled with Goldman, Sachs & Co. as follows: Goldman, Sachs & Co. took back the notes, paid Fundamental \$5.25 million in cash and assigned to Fundamental a 73.75 per cent interest in the proceeds of the \$20 million of notes in the reorganization proceedings (37 A).

On July 24, 1974, at their next regular meeting, the Board of Directors of Fundamental reviewed the status of the Lasker action (39 A), and determined that the five directors who (a) were not affiliated in any way with Anchor, and (b) were not directors at the time of the events complained of in the Lasker action, and (c) were not defendants in the Lasker action, would, acting as a quorum pursuant to the by-laws, constitute the Board of Directors to decide what position Fundamental should take regarding the Lasker action. The other directors would take no part in the decision (39 A-40 A).

To assist them in their deliberations, the five disinterested directors retained independent special counsel (41 A), Hon. Stanley H. Fuld, former Chief Judge of the State of New York (41 A).

On December 5, 1974, after several months of investigation, Judge Fuld reported the results of his analysis in a comprehensive legal and factual memorandum (41 A; 56 A-95 A), and advised:

"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provisions of statute or of any common law or contractual obligation to the fund, in connection with the acquisition and retention of the Penn Central commercial paper." (57 A).

Judge Fuld also identified and analyzed the alternative courses of action available to the directors (93 A-95 A), and concluded his memorandum as follows:

"It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt."

On January 6, 1975, having conferred further with Judge Fuld in the interim, the five disinterested directors held another special meeting of the Board in New York City, away from Anchor and not attended by any of the defendants (46 A-47 A). After several hours of deliberation of the alternatives available, they voted to instruct their litigation counsel to move to dismiss the action as contrary to the best interests of Fundamental (50 A). Their reasoning is set forth at length in the record (47 A-49 A).

Judge Werker endorsed the basic theory of the motion to dismiss, but denied it with leave to renew following discovery.

Judge Werker wrote (404 F. Supp. at 1180):

"If the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board." (95 A).

At the conclusion of extensive discovery proceedings, Fundamental renewed its motion to dismiss (160 A). Judge Werker granted the renewed motion and wrote (426 F. Supp. at 849):

"Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently." [emphasis supplied].

On January 11, 1978, in an opinion devoid of supporting authority and contrary to all relevant precedents, the panel that heard the appeal reversed and remanded the case. In so doing, the panel necessarily and erroneously concluded that, as a matter of law, disinterested directors of a mutual fund cannot be trusted to reach a sound and honest business judgment even when the District Court finds that this is precisely what they have done --- this result is an unreasoning indictment of an entire class of people, and is also squarely in conflict with the statutory presumption of independence embodied in Section 2(a)(9) of the Act* as well as the strong findings of the District Court and all relevant legal authorities.

*

"A natural person shall be presumed not to be a controlled person within the meaning of this title."
15 U.S.C. §80a-2(a)(9).

Point I --- the decision is contrary to
Congressional intent as expressed in the Act.

Judge Lumbard reasoned that, since in the 1970 amendments to the Act, Congress "specifically provided in Section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser," it "would surely be anomalous" not to imply the same power for violations of Section 36(a) of the Act. (Slip Opinion, at 999). Why it would be "anomalous" is not explained, nor is any authority offered for the proposition.

Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Act --- it is a unique and highly specific section dealing solely with the subject of investment advisory fees. Section 36(b) expressly creates a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees, irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.

If Congress had wanted to provide in Section 36(a) (a far broader section than Section 36(b)) the unique mechanisms of Section 36(b), it could and would have done so in the 1970 amendments --- it did not do so. The panel that decided this appeal simply added a provision to Section 36(a) where Congress saw fit not to do so.

The legislative history, which is not cited by Judge Lumbard, further supports the defendants' view of this matter.

Thus, Senate Report No. 91-184 states:

"Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)." [emphasis supplied]. 3 U.S. Code Cong. & Ad. News. 91st Congress, at p. 4911 (1970).

Senate Report No. 91-184 expressly reaffirmed the authority of disinterested directors to manage the affairs of the fund in the exercise of their business judgment:

"These provisions highlight the fact that the section [Section 36] is not designed to ignore concepts developed by the courts as to the authority and responsibility of the directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." [emphasis supplied] Id., at p. 4903.

Judge Werker correctly analyzed and rejected the plaintiffs' argument based on Section 36(b), and held that (404 F. Supp. at 1179-80):

"This Court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which

allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act it is true that causes of action under those Acts are implied rights of action. Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), aff'd 294 F.2d 415 (2d Cir. (1961)); Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (S.D.N.Y. 1974). It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final."

Further, on the motion for reargument, Judge Werker again correctly rejected the plaintiffs' Section 36(b) argument, and held, in an unreported opinion:

"That section [36(b)] specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under section 36(a)...where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim." (158 A-159 A).

Point II --- the decision is in irreconcilable conflict with sound precedent regarding the applicability of the business judgment rule to mutual fund directors.

In holding that the directors at bar did not have the power, as a matter of law, to exercise their business judgment to terminate this litigation, Judge Lumbard wrote, in footnote 14 (Slip Opinion, p. 1,000):

"We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations."

The notion that mutual fund directors --- especially the disinterested directors --- are under a special disability in regard to exercising business judgment, has been firmly rejected by the Court of Appeals for the First Circuit in the leading case of In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir. 1973) cert. denied 414 U.S. 857 (1973). Judge Aldrich, a recognized authority in this field, there wrote (pp. 266-7 of 479 F.2d):

"...the underlying business judgment may be sufficiently unsound to call for correction. But it does not follow that it is to be conclusively presumed in such a case that an unaffiliated, or disinterested director, if demand were made upon him, would be unable to exercise an independent judgment in considering what new course to take." [footnote and citation omitted].

"Nor do we think that an exception is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties --- their approval or acquiescence making them 'wrongdoers' --- once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. Normally self dealing by any corporate directors is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. In order to make sure that the directorate not be top-heavy, it [Congress] provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from a disinterested director in any other corporate venture. All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' [citation omitted]. When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim,' [citation omitted], it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response. [citation omitted]. To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it."
[emphasis supplied].

Point III --- the decision is contrary
to prior decisions of this Court.

This Court recently recognized, in Tannenbaum v. Zeller, 552 F.2d 402, 417 (2d Cir. 1977), that the disinterested directors of a mutual fund have the authority to exercise a binding business judgment, provided it is reasonable, even on matters as to which there is a conflict of interest affecting the adviser and the interested directors of the fund (e.g., the allocation of brokerage fees on portfolio transactions of the fund):*

"We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors."

This Court also recognized the applicability of the business judgment rule to disinterested directors of mutual funds in Fogel v. Chestnutt, 553 F.2d 731, 749-50 (2d Cir. 1975) cert. denied 429 U.S. 824 (1976). Chief Judge Friendly there wrote:

*

The SEC, at the request of this Court, submitted an amicus curiae brief in Tannenbaum expressly acknowledging the applicability of the business judgment rule to the acts of mutual fund directors.

"Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation or recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.

"If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case."

The decision by the panel is squarely in conflict with the rationale and holdings of this Court in Tannenbaum and Fogel.

Point IV --- the decision is in irreconcilable conflict with recent Supreme Court cases regarding the primacy of state law.

Congress saw fit to have mutual funds organized under state law --- they are not like national banks. Fundamental is a Delaware corporation and, in the absence of any express provision of federal law to the contrary, the powers of the directors are governed by state law, i.e., by the law of Delaware. There is no provision of Delaware law disabling the disinterested directors from making the decision to terminate this derivative litigation.

The Supreme Court last year reaffirmed the primacy of state law regarding the powers of directors in Santa Fe Industries, Inc. v. Green, --- U.S. ---, 51 L.Ed. 2d 480, 496 (1977):

"Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." [quoting from Cort v. Ash, 422 U.S. 78, 84 (1975)] [emphasis in original].

The opinion by Judge Lumbard also erroneously stresses the fact that the decision to terminate this litigation was made by "minority directors". Delaware Corporation Law, Section 141 expressly provides for a quorum of less than a majority. This is wholly consistent with the Act. Indeed, since the interested directors are disqualified under the Act from participating in certain functions of the Board (e.g., approval of the advisory contract, etc.), the fund's board would be paralyzed if it could not operate by a quorum composed of a minority of the directors.

Delaware law contains no limitation on the powers of a duly constituted quorum to terminate derivative litigation; the quorum acts as the Board of Directors, and can transact any business of the Board. The decision by the panel directly contravenes this grant of authority to the quorum and, in effect, legislates new provisions of corporate law not provided for by Delaware or by

Congress. In the absence of an express provision of federal law to the contrary on this matter, such judicial legislation in derogation of state corporate law is forbidden.

Point V --- the decision improperly compels maintenance of litigation not in the best interests of the fund.

The opinion of Judge Lumbard in seeking to draw distinctions between "frivolous" and "non-frivolous" actions (Slip Opinion, p. 1,000) engrafts another limitation on the business judgment powers of the disinterested directors which is not found in the Act, and improperly ignores the many factors other than the strength or weakness of the underlying claim which go into the exercise of business judgment not to pursue a claim in litigation. Those factors have long been recognized by the Courts. See cases cited in Brief of Defendants-Appellees, p. 16.

As the Supreme Court stated in Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903):

"The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce

every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs."

Chief Judge Kaufman summed the matter up well in Alleghany Corp. v. Kirby, 344 F.2d 571, 573 (2d Cir. 1965) cert. denied 384 U.S. 28 (1966):

"We know of no proposition of law that permits shareholders, absent any allegations of bad faith, collusion or negligence, concededly neither present nor charged here [citation omitted] --- to intervene, as of right, in order to continue litigation that independent members of the Board of Directors, acting in good faith and in the exercise of sound business judgment have decided to terminate."

Conclusion

The petition for rehearing in banc should be granted and the reversal and remand by the panel should be vacated.

Respectfully submitted,

Seward & Kissel

Pollack & Kaminsky

Dewey, Ballantine, Bushby,
Palmer & Wood

Affidavit of Service by Mail

State of New York)
 : ss.:
County of New York)

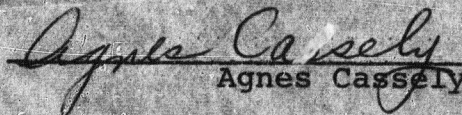
Agnes Cassely, being duly sworn, deposes and says:

I am not a party to this action; and I am over 18 years of age.

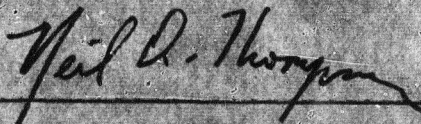
On the 25th day of January, 1978, I served two (2) copies of the within Petition by Appellees for Rehearing in Banc upon

Aranow, Brodsky, Bohlinger, Benetar & Einhorn
(attorneys for plaintiffs-appellants)
at 469 Fifth Avenue
New York, New York 10017,

the address designed by said attorneys for that purpose by depositing a true copy of same enclosed in a postpaid, properly addressed wrapper, in an official depository under the exclusive care and custody of the United States Postal Service within the State of New York.


Agnes Cassely

Sworn to before me this
25th day of January, 1978.



NEIL D. THOMPSON
Notary Public, State of New York
No. 31-9325840
Qualified in New York County
Commission Expires March 30, 1978